

Internal Revenue Service
memorandum

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to: District Counsel, Kansas City CC:KCY

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject:

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This is in response to your request of September 25, 1990, for tax litigation advice in which you requested our views on the position taken in a draft of Memorandum for Assistant Attorney General Peterson. The Department of Justice trial attorney takes the position in the Memorandum that the validity of Treas. Reg. § 1.471-1 cannot be defended.

ISSUE

Whether the Government should defend Treas. Reg. § 1.471-1, which specifies that only goods which physically become a part of the final product can be inventoried. 0471-0900

CONCLUSION

Treas. Reg. § 1.471-1 is a valid interpretation of the law in specifying that only goods which physically become a part of the final product can be inventoried. As such, it is entitled to deference by the courts, and the government should defend it.

FACTS

Taxpayer is a manufacturer of products derived wholly or partly from corn. Taxpayer uses coal to heat boilers that generate steam, which is used in the production process to dry corn products and to induce chemical reactions such as fertilization. The coal is consumed in the manufacturing process and does not physically become part of any of the taxpayer's finished manufactured products. Taxpayer desires to include the coal in its inventory so that it can use the last-in, first-out (LIFO) inventory method to value the coal regardless of how it actually consumes the coal.

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DISCUSSION

I.R.C. § 471 provides that when the Secretary determines that the use of inventories is necessary in order to clearly reflect income, inventories shall be taken by the taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treas. Reg. § 1.471-1 provides that in order to correctly reflect income, inventories should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of the merchandise intended for sale.

Section 472 provides for the use of the LIFO inventory method. Treas. Reg. § 1.472-1(a) provides that with respect to those goods properly subject to inventory, a taxpayer may compute his opening and closing inventories in accordance with the method provided by section 472, i.e., LIFO.

In the process of determining net income from the manufacturing process, different methods are used to account for the various types of costs associated with the process and to properly match income and expenses. In a manufacturing process, the whole accounting structure is geared to properly associate the costs of producing the final product such that these costs will be deductible only when income is earned from the sale of the product. While theoretically all the costs incurred by a manufacturing concern are ultimately associated with the production of the income producing product, some of these costs are more easily associated with the product than others. For example, the direct labor and raw materials which go into the product are easily associated with the final product. These costs are inventory costs and are accounted for under section 471 and its regulations.

Many other costs are incurred in the production of the final product, however, but are not so directly identifiable with the product. For example, at one end of the spectrum are capital plant and equipment, which are worn away during the production process. These costs are accounted for by various methods of depreciation under sections 167 and 168. At the other end of the spectrum are items such as company stationery which would seem to be indisputably accounted for as a deferred expense under section 162 and Treas. Reg. § 1.162-3. Frisco Sugar Company v. Commissioner, 47 F.2d 555, 558 (2d Cir. 1931).

Once costs are termed inventory costs, the regulations under section 471 provide for specific treatment of these costs and offer various alternatives in the accounting treatment. An

important benefit of a cost being labeled an inventory cost is that its cost for tax purposes can be determined at cost or the lower of cost or market. The effect of this is that when there has been a market development which theoretically will ultimately affect the value of the final product, the regulations allow a taxpayer to account for such development immediately rather than waiting for the final sale. Treas. Reg. § 1.471-4. Thus, the taxpayer can take a paper loss in advance of the realization of such a loss by sale of the product or other disposition of the property. See, e.g., Burroughs Adding Machine Co. v. Commissioner, 9 B.T.A. 936, 943 (1927). Another benefit of identifying costs as inventory costs is that they may be accounted for under the last-in, first-out (LIFO) method of inventory accounting. Section 472 and Treas. Reg. § 1.472-1(a).

The types of costs which are eligible for this favorable inventory treatment are described in Treas. Reg. § 1.471-1, which provides that "[t]he inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale...." In so providing, this regulation limits the eligibility for favorable inventory treatment to those costs which lie somewhere between capital plant and equipment and office stationery. Such a limitation is reasonable because it would be inappropriate for certain costs to receive the benefit of early write-off or paper losses when the loss would never be realized directly by sale or other disposition of the property. Burroughs Adding Machine, 9 B.T.A. at 943.¹

Thus, the Service limited the costs eligible for the benefits of inventory accounting to those where the potential loss from the write-down to market would be directly realized by a sale of the product by requiring that in the case of raw materials and supplies, only those costs associated with goods acquired for sale or which will physically become a part of merchandise intended for sale could be accounted for under the section 471 regulations. It was evidently the Service's determination that such a system would be the one to most clearly reflect income. This regulation is a reasonable one in view of the statute's requirement of a clear reflection of income and is not inconsistent with the revenue statutes. Thus, it should be upheld by the courts. Commissioner v. South

¹ In contrast, materials and supplies not inventoriable are treated as deferred expense items under Treas. Reg. § 1.162-3 and are valued at cost. Valuation at cost is appropriate and most clearly reflects income when the item will not generally be directly sold or otherwise disposed of in the market.

Texas Lumber Co., 333 U.S. 496, 501 (1948). "[T]he choice among reasonable alternatives is for the Commissioner, not the courts." National Muffler Dealers Association v. United States, 444 U.S. 472, 488 (1979).

Until 1933, Treas. Reg. § 1.471-1, provided that inventory should include raw materials and supplies consumed or used in the production process. The Service, however, has always interpreted the regulation as eliminating from inventoriable assets current supplies that are more in the nature of deferred expenses. Burroughs Adding Machine Co. v. Commissioner, 9 B.T.A. 938 (1927); Frisco Sugar Company v. Commissioner, 14 B.T.A. 1062 (1929), rev'd, 47 F.2d 555 (2d Cir. 1931); Aluminum Company of America v. United States, 24 F. Supp. 811 (W.D. Pa. 1938). The government prevailed in Burroughs, while the latter two cases held, contrary to the government's position, that items of supply that were not held for sale and did not become a physical part of any finished product nevertheless were inventoriable items to which the lower of cost or market valuation method could be applied. When the government was not able to prevail on its position largely because of the language of the regulation, the language of the regulation was changed to read as it does currently.²

The current regulation has been cited with approval by the courts. In Madison Gas and Electric Company v. Commissioner, 72 T.C. 521 (1979), aff'd on other grounds, 633 F.2d 512 (7th Cir. 1980), the court quoted section 1.471-1 of the regulations with approval and adopted the position of the parties that coal

² We recognize that the court in Aluminum Company, in addition to citing the early inventory provision discussed above which was changed in 1933, found support for its decision in another inventory provision, article 1583 of regulation 45, which was not changed in 1933 and is identical to Treas. Reg. § 1.471-3(c). That provision provides in part that "cost" means: "In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product *** (emphasis added). Since the underscored language can be construed, as in Aluminum Company, to mean that supplies (not acquired for sale) that do not physically become part of merchandise acquired for sale are inventoriable under section 471; it is possible that the Service may have neglected to amend article 1583 when the 1933 change was made. In any event, the construction of the underscored language must be viewed as being controlled by the language in Treas. Reg. § 1.471-1 that relates back to the 1933 change. That Treas. Reg. § 1.471-1 is controlling over Treas. Reg. § 1.471-3(c) in this respect is consistent with the heading and apparent purpose of those provisions.

used in generating electricity was not a material that will physically become a part of the merchandise intended for sale. Thus, it was not an item includible in inventory under section 471. The taxpayer's deduction for the coal was controlled by Treas. Reg. § 1.162-3.

In support of this position the government cited section 471 as giving the Commissioner authority to determine whether inventories are necessary to clearly reflect income and to prescribe rules for their handling in accordance with the best accounting practices of the trade or business. The Government does not regard coal used to generate electricity as "physically becomin[ing] a part of merchandise intended for sale" in the ordinary everyday sense of those words.

The taxpayer, in order to be able to inventory its coal on a LIFO basis, would challenge the validity of Treas. Reg. § 1.471-1. The taxpayer offers several arguments for this. First, it argues that its inventory accounting method meets generally accepted accounting (GAAP) principles and is a clear reflection of income. This argument has been disposed of by the Supreme Court. In Thor Power Tool Company v. Commissioner, 439 U.S. 522 (1979), the Court stated that on their face sections 446 and 471 vest the Commissioner with wide discretion in determining whether a method of inventory accounting should be disallowed as not clearly reflecting income. In addition, the taxpayer bears a heavy burden of proof and the Commissioner's interpretation of a statute should not be overturned unless clearly unlawful. The Court cited Lucas v. Structural Steel Co., 281 U.S. 264, 271 (1930), to the effect that the Commissioner's disallowance of an inventory accounting method is not to be set aside unless shown to be plainly arbitrary.

The Court stated that there is no presumption that an inventory practice conforming to GAAP is valid for tax purposes. The reasons are: (1) the Code and regulations give the Commissioner broad discretion to set aside a method that in his opinion does not clearly reflect income; (2) there is no support in prior Court decisions, citing Frank Lyon Co. v. United States, 435 U.S. 561, 577, (1978), for the proposition that the treatment of a transaction for financial accounting purposes on the one hand, and for tax purposes on the other, need necessarily be the same; (3) the presumption is insupportable in light of the vastly different objectives of financial and tax accounting; and (4) the presumption would create insurmountable administrative burdens. But even were there such a presumption, it must yield when inconsistent with regulations. Thor Power Tool, 439 U.S. at 542-43.

The taxpayer further argues that Treas. Reg. § 1.471-1 is invalid because it is inconsistent with Treas. Reg. § 1.471-1(b)(2). This full absorption regulation requires inclusion in inventory of all "direct production costs," including material consumed in the ordinary course of manufacturing. In this argument, the taxpayer confuses two distinct concepts of inventory. In the first we have coal that has been bought but has not yet been used in the production process. Treas. Reg. § 1.471-1 applies to this coal and, thus, it is not inventoriable because it will not physically become a part of the merchandise intended for sale. In the second concept we have the coal actually consumed during the year in the production process. Once the production process begins, the full-absorption, inventory-costing rules apply. Under these rules, the values of the merchandise in process and of the finished product are determined. It is at this point that indirect costs, such as the cost of the coal, are included in determining the inventory value. For this purpose, it is immaterial whether the coal physically becomes a part of the merchandise intended for sale. Although the cost of the coal used during the production process is used to value the inventory of the merchandise intended for sale, this is not before being used in the production process.

For an analogous situation, see Rev. Rul. 75-491, 1975-2 C.B. 19, which holds that molten tin used in the float process manufacture of flat glass is not depreciable property and does not qualify as section 38 property for investment credit purposes. The tin is not a material of construction that becomes a part of the depreciable property. The cost of the tin consumed is deductible under section 162 of the Code as an expense of operation, subject to being includible in the inventoriable cost of producing the glass as a direct production cost.

The taxpayer also argues that the I.R.S. 1976 Training Manual on Inventories is inconsistent with the position that materials "must physically become a part of" the merchandise intended for sale. The Training Manual is not a source of authoritative tax law.

Finally, the taxpayer argues that Treas. Reg. § 1.471-1 does not exclude major raw materials and supplies from income. The taxpayer, however, has not cited any direct support for its position. Rather, it cites cases prior to the 1933 change in the regulation in which it was held, contrary to the government's position, that various small tools, minor supplies, and spare parts consumed in the production process were includible in inventory. Based on this, the taxpayer asserts that major supplies such as those in the instant case are not covered in the regulation's 1933 change. Rebuttal to this argument is dealt with above.

None of the taxpayer's arguments are sufficient to overturn the regulation. The regulation is a reasonable solution for drawing a line which is justified by the legitimate concerns to collect the revenue. It has been in existence for fifty-seven years. Based on this it is entitled to deference by the courts.

If you have any questions, please contact Virginia L. Draper at FTS 566-3521.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division